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REPORT OF THE EXPERT MEETING ON THE GROWTH OF DOMESTIC CAPITAL MARKETS, PARTICULARLY IN DEVELOPING COUNTRIES, AND ITS RELATIONSHIP WITH FOREIGN PORTFOLIO INVESTMENT

Held at the Palais des Nations, Geneva,
from 27 to 29 May 1998

CONTENTS

		Page
I.	Agreed conclusions	2
II.	Chairperson's summary	4
III.	Organizational matters	8

Annex

	Attendance	10

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I. AGREED CONCLUSIONS [1]

1. After a lively discussion on the issues related to the relationship between the growth of domestic capital markets and foreign portfolio investment, a common understanding on the following issues emerged:

(i) It was recognized that portfolio investment is assuming an increasing importance as one of the sources of finance for developing countries and countries in transition, as well as industrialized countries. Furthermore, as the domestic financial system becomes more sophisticated, the distinction between foreign direct investment and foreign portfolio investment may become blurred due to the fact that direct investors can use financial engineering techniques to convert foreign direct investment into a more liquid form of investment.

(ii) If the benefits of the free movement of capital flows are to be retained, the problems of financial instability and negative socio-economic effects of financial turmoil need to be addressed at the national and international levels. In a world of highly mobile capital flows and financial instability, sound macroeconomic fundamentals and appropriate monetary and fiscal policies are necessary, but they are not sufficient on their own to attract stable investment flows and avoid financial turmoil.

(iii) It was also agreed that the existence of a healthy financial system, governed by a good regulatory framework and strong supervision which would oversee the operations of the banking sector and the securities and insurance sectors, is an important prerequisite in preventing financial crises. The potential benefits of internationally agreed principles, such as the Basle Committee Core Principles for Effective Banking Supervision, were recognized.

(iv) Discussion on the ongoing process of financial liberalization suggests that countries may prefer to adopt a prudent and well-sequenced process of internal and external financial liberalization, according to the level of their development and particular circumstances, analysing the effects of each liberalization phase before proceeding further.

(v) It is also necessary to encourage domestic savings and the development of domestic capital markets and institutional investors, including collective investment schemes such as pension funds and mutual funds, so as not to be dependent on external financing of investment. This would also help to minimize the consequences of international financial crises.

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[1] As adopted by the Expert Meeting at its closing plenary meeting on 29 May 1998.

(vi) The choice and maintenance of an appropriate exchange-rate regime, according to the specific circumstances of each country, also plays an important role in reducing financial instability.

(vii) It was agreed that regional cooperation should be encouraged in order to strengthen the capacity of countries of the same region to cope with financial instability. Such cooperation could take the form of monetary and financial cooperation, as well as standardization of financial disclosure rules, accounting standards and enforcement rules.

(viii) It is of the utmost importance to increase the transparency of information at the macro- and micro-level of a country. The transparency and quality of financial information concerning market operators and the standardization of statistical data and financial statements are also essential.

(ix) It is also of the utmost importance to improve the current global financial system in response to the challenges posed by the globalization of financial markets.

(x) It is recommended that UNCTAD should continue to examine measures that would help developing countries, especially the least developed countries, to design adequate policies to attract stable foreign investment flows. The UNCTAD secretariat should continue to work in this area in cooperation with other relevant international and regional institutions.

II. CHAIRPERSON'S SUMMARY

1. The benefits derived from capital flows and trade in assets in terms of supplementing domestic savings, providing technology and know-how and improving corporate governance were widely recognized. However, there was a need for a better understanding of the risks associated with the widespread liberalization and globalization of financial markets, including the rapid integration of emerging market economies into the global financial system.

2. There was a general recognition that, given the changing structure of international financial markets, portfolio investment had assumed an important role as one source of external finance for emerging markets. In some emerging market countries, the development of domestic capital markets had also allowed domestic savings to be increasingly channelled through those capital markets.

3. However, although longer-term portfolio investment was welcome, concern was expressed about the high volatility of that type of investment. Opinions diverged about the role of portfolio investors in the development of the recent financial crisis in East Asia. On the one hand, it had been shown that portfolio investors, particularly United States mutual funds, appeared to have reacted to the East Asian crisis in a measured fashion. Shareholders in United States emerging market mutual funds had withdrawn modest portions of their investments on a steady basis, and the purchases and sales by portfolio managers, although correlated with returns, appeared to have been quite limited in comparison to the degree of market volatility. On the other hand, it was said that the sudden general withdrawal of investments during the crisis from countries which appeared to have good fundamentals had caused major disruptions to domestic financial systems through drastic changes in liquidity and sharp declines in stock market prices.

4. To cope with the volatility of portfolio investment, there were proposals to implement new measures, at both the country and regional levels, such as:

(i) Encouraging the establishment of closed-end funds as opposed to mutual funds, since investments in the former were relatively stable (as they were not bound by redemption obligations). However, it was pointed out that investors were less interested in putting their money in closed-end funds because those funds tended to be traded at a discount.

(ii) Issuance of American and global depository receipts and other similar instruments at the regional level, such as a South-East Asian depositary receipt, which would be issued in a stronger, more stable economy of the region. Some participants argued that issues of American depository receipts and global depository receipts did not contribute to the development of domestic capital markets. Those instruments could reduce the volatility of investment flows but, owing to arbitrage trading, local markets could not be completely insulated from the effects of price volatility.

(iii) Provision of special incentives to encourage a minimum holding period (six months to one year) for foreign portfolio investments. Those incentives should be implemented across neighbouring countries or on a regional basis so as to ensure their

effectiveness. Some countries had adopted a system of differentiated tax treatment according to the duration of the investment. However, those tax incentives might not be effective in encouraging long-term investment because new information could trigger sales despite tax incentives. It was pointed out that tax incentives and a minimum holding period should be equally applied to foreign and domestic investors. However, as United States mutual funds were legally obliged to redeem shares within a period of three to seven days, the imposition of a minimum holding period would represent a very strong disincentive to investments by those funds. Some countries had imposed reserve requirements for capital inflows which were in effect equivalent to the imposition of a tax.

(iv) Mobilization of domestic savings through appropriate legislation and incentives in order to minimize dependence on foreign capital. In that respect, the development of a domestic institutional investor base such as pension funds and mutual funds would help to increase the domestic savings rate.

(v) Establishment of a dialogue with fund managers in order to motivate and convince them to treat emerging markets as long-term partners.

(vi) Regional monetary cooperation would help to minimize a misalignment of currencies in the region, thus reducing the risk of speculative attacks. The creation of a common-currency-basket peg for countries from the same region was proposed in order to reduce the occurrence of competitive devaluations. Moreover, there would be merit in adopting, initially on a regional basis, common standards and rules on financial reporting, corporate disclosure, business ethics and enforcement.

(vii) Stability of the real exchange rates at an appropriate level was a key element in encouraging sound investments as it sent the right signals to investors. A certain degree of nominal exchange-rate flexibility would remove the implicit guarantee against exchange-rate risk that was inherent in a completely fixed exchange-rate system, especially when it was very costly for the Government of a country to defend its fixed exchange rate. Excessive exchange-rate instability could be detrimental to foreign trade and could increase costs for firms, which had to protect themselves against exchange-rate fluctuations.

5. It was also noted that in more sophisticated markets the distinction between long-term and short-term investments (for example between direct investment and short-term capital flows) was blurred, as foreign direct investors could use complex financial engineering techniques to make their investments more liquid. That did not, however, eliminate the fundamental differences in the characteristics of foreign direct investments and portfolio investment: the former implied a long-term commitment, while the latter was attracted by capital gains derived from security price movements.

6. In relation to financial crises, it was mentioned that the social and economic costs for the affected countries were extremely high. In that respect, sound fundamentals were critical in minimizing the risk of being exposed to

financial turmoil. However, following recent financial crises, the range of criteria encompassing the fundamentals had widened beyond the more traditional macroeconomic factors to include new elements such as the health of domestic financial markets, the quality of bank regulations, supervision, and bankruptcy laws and enforcement rules.

7. Discussion on finance for development indicated that there were three objectives that a good financial system should fulfil at the national and international levels: (1) the effective build-up and efficient allocation of savings; (2) the provision of safeguards and buffers against shocks, and an adequate response to crises; and (3) the provision of a smooth and steady flow of private financing to developing countries. It was important not to seek the perfect system before establishing a framework to meet those three objectives, but rather to implement what appeared to be a reasonably sound framework and then to make gradual improvements over time.

8. With respect to the first objective, it did not necessarily imply financial liberalization, which could under certain circumstances actually lead to disastrous results, but it might imply financial restructuring. Regarding the second objective, safeguard measures would entail a system of deposit insurance, a lender of last resort, emergency credit lines, and the holding of adequate official reserves, including a new orientation in the management of foreign exchange reserves in the light of more mobile capital flows. At the international level, it would also entail a lender of last resort, such as the International Monetary Fund and, in some cases, the Bank of International Settlements. The th e objectives should also be pursued through an adequate regulatory and supervisory framework.

9. With respect to the question of whether sound banking supervision could prevent the occurrence of asset bubbles, it was mentioned that sound macroeconomic conditions, together with sound banking supervision, could to some extent reduce the frequency of such asset bubbles, but would not be able to completely eliminate them. It was also pointed out that while the cost of banking supervision was indeed high, the cost of poor supervision had proved to be even higher.

10. Five preconditions were noted with respect to effective banking supervision:

(i) Sound and sustainable macroeconomic policies;

(ii) A well-developed public infrastructure which should include a system of business laws, well-defined accounting principles and rules, independent audits and a secure and efficient payment and clearing system for the settlement of financial transactions;

(iii) Effective market discipline, which depended on an adequate flow of information to market participants, appropriate financial incentives to reward well-managed institutions and arrangements that ensured that investors were not insulated from the consequences of their decisions;

(iv) Procedures for the efficient resolution of problems in banks;

(v) Mechanisms for providing an appropriate level of systemic protection (or public safety net).

11. Supervision could not, and should not, provide an assurance that banks would not fail. In a market economy, failures were a part of risk-taking. Implementation was the most critical aspect, and it represented a process that by its nature might be quite a long one, depending on the initial conditions prevailing in a given country. The core principles were a set of guidelines aimed at providing a general framework for effective banking supervision, which should be supplemented at the country level in the light of country-specific conditions and risks. In some countries, much of the legal and institutional framework necessary for the effective implementation of the guidelines already existed, and full implementation could take place relatively quickly. In other countries, the process might require a number of major changes that would take longer, including the implementation of appropriate legal changes (to provide for contract law, property rights, collateral arrangements, and insolvency and bankruptcy arrangements), and steps to increase the availability of skilled market practitioners in the areas of law, accounting, credit analysis and risk management, and private-sector apparatus (including credit-rating agencies and private analysts).

12. It was stated that all banks needed to be brought under effective supervision, regardless of where they operated from, including those in offshore financial centres. The question was raised as to whether the banking supervisory function should be carried out within the central bank or not; most countries felt that it was more appropriate and effective that it should be within the central bank. The supervisory framework should cover not only banks, but also non-banking financial institutions, including specifically the other two main pillars of a financial system - securities companies and insurance companies.

13. It was widely recognized that a system of deposit insurance was necessary, despite the risk of moral hazard that it could give rise to. Several issues related to the design of such a system were raised, such as fee-based contributions, public funding, government guarantees and the participation of foreign institutions.

14. In addition to issues related to supervision and the legal framework of the financial system, experts also emphasized that a prudent and well-sequenced liberalization process of the internal and external financial sectors should be pursued in order to minimize the risks of financial turmoil. It was generally agreed that trade liberalization should precede internal financial liberalization, which would then be followed by capital account liberalization. It was noted that several countries which had adopted controls on short-term capital flows were among those that were the least affected by financial crises. However, countries should not allow capital controls to delay the implementation of sound policies and reforms in the financial sector.

III. ORGANIZATIONAL MATTERS

A. Convening of the Expert Meeting

1. In accordance with the recommendation made by the Commission on Investment, Technology and Related Financial Issues at the closing meeting of its second session on 3 October 1997,[2/] the Expert Meeting on the Growth of Capital Markets, Particularly in Developing Countries, and its Relationship with Foreign Portfolio Investment was held at the Palais des Nations, Geneva, from 27 to 29 May 1998. The meeting was opened on 27 May 1998 by Mr. Rubens Ricupero, Secretary-General of UNCTAD.

B. Election of officers

(Agenda item 1)

2. At its opening meeting, the Expert Meeting elected the following officers to serve on its Bureau:

Chairperson:	Mr. Franz Nauschnigg	(Austria)
Vice-Chairperson-cum-Rapporteur:	Mr. Paul Melly	(Kenya)

C. Adoption of the agenda

(Agenda item 2)

3. At the same meeting, the Expert Meeting adopted the provisional agenda circulated in TD/B/COM.2/EM.4/1. Accordingly, the agenda for the Meeting was as follows:

1. Election of officers
2. Adoption of the agenda
3. The growth of domestic capital markets, particularly in developing countries, and its relationship with foreign portfolio investment
4. Adoption of the outcome of the Meeting

[2/] See Report of the Commission on Investment, Technology and Related Financial Issues on its second session (TD/B/44/14-TD/B/COM.2/7), paragraph 51.

D. Documentation

4. For its consideration of the substantive agenda item (item 3), the Expert Meeting had before it a report by the UNCTAD secretariat entitled "The growth of domestic capital markets, particularly in developing countries, and its relationship with foreign portfolio investment: Issues for consideration" (TD/B/COM.2/EM.4/2).

E. Adoption of the report

(Agenda item 4)

5. At its closing meeting, on 29 May 1998, the Expert Meeting adopted the agreed conclusions reproduced in section I above, and authorized the Chairperson to prepare a summary of the Meeting (see section II above).

Annex

ATTENDANCE */

1. Experts from the following States members of UNCTAD attended the meeting:

Algeria
Austria
Bangladesh
Belarus
Benin
Brazil
Canada
China
Costa Rica
Cuba
Czech Republic
Democratic Republic of the Congo
Egypt
France
Greece
Hungary
India
Indonesia
Iran (Islamic Republic of)
Italy
Jamaica
Japan
Jordan
Kenya
Lebanon
Malaysia
Mexico
Namibia
Niger
Nigeria
Pakistan
Peru
Philippines
Poland
Republic of Korea
Republic of Moldova
Romania
Russian Federation
Senegal
Slovakia
Spain
Sri Lanka
Sudan
Switzerland
Thailand
Trinidad and Tobago
Tunisia
Turkey
Uganda
United Kingdom of Great Britain and Northern Ireland
United States of America
Uruguay
Venezuela
Yemen

2. The following intergovernmental organizations were represented at the meeting:

African, Caribbean and Pacific Group of States
Agency for Cultural and Technical Co-operation
Andean Community
Arab Labour Organization
Inter-American Development Bank
League of Arab States
Organisation for Economic Co-operation and Development
Organization of the Islamic Conference

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*/ For the list of participants, see TD/B/COM.2/EM.4/INF.1.

3. The following specialized agency and related organization were represented at the meeting:

International Monetary Fund
World Trade Organization

4. The following non-governmental organizations were represented at the meeting:

General Category

International South Group Network
Third World Network
World Association of Small and Medium Enterprises
World Federation of United Nations Associations
World Savings Bank Institute

Panellists

Mr. Charles Freeland, Deputy Secretary General, Basle Committee on Banking Supervision, Bank for International Settlements
Mr. Hans Genberg, Professor, Graduate Institute of International Studies, Director of the International Center for Monetary and Banking Studies, Geneva
Mr. Gerry Helleiner, Professor of Economics, University of Toronto, Canada, Coordinator of G-24 Research Project
Ms. Mary Podesta, Senior Counsel, Investment Company Institute, Washington DC, United States of America
Mr. Mitchell A. Post, Assistant Vice President, Research and Deputy Chief Economist, Investment Company Institute, Washington DC, United States of America
Mr. Perfecto Yasay, Jr., Chairman, Securities and Exchange Commission of the Philippines

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